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No. 93-1315

In the Supreme Court of the United States

OCTOBER TERM, 1993

ROBERT M. PECK, TRUSTEE FOR THE ROBERT M. PECK, M.D., INC., DEFINED BENEFIT PENSION TRUST, ET AL., PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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QUESTION PRESENTED

Whether, on the facts of this case, the claim of the United States for taxes owed on income received from embezzlement has priority under 31 U.S.C. 3713 in the assets assigned by the embezzler for the benefit of his creditors.

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OPINIONS BELOW

The opinion (Pet. App. D1-D10) and amended opinion (Pet. App. F1-F11) of the court of appeals are unreported, but the judgment is noted at 9 F.3d 1550 (Table). The opinion of the district court (Pet. App. A1-A22) is unreported.

JURISDICTION

The judgment of the court of appeals was entered on September 22, 1993. The amended opinion of the court of appeals was filed on November 2, 1993. The petition for rehearing was denied on that same day (Pet. App. G1-G2). The petition for a writ of certiorari was filed on January

28, 1994. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. An investment advisor named Stephen Henry embezzled funds from petitioners. "On October 1, 1986, [petitioners], weary of Henry's excuses for not returning their money, sued Henry and attached his real property" (Pet. App. D3). Petitioners commenced this action in state court. Due to petitioners' allegations of civil RICO violations (18 U.S.C. 1964) by Henry, the case was removed to federal district court.

On November 18, 1986, Henry made a general assignment of his assets for the benefit of his creditors to Earle Hagen (Pet. App. D3-D4):

> Henry's assets were worth approximately $1,000,000 and his clients claimed the entire estate. In addition, Henry's wife held a promissory note signed by Henry for $305,000, and First Professional Bank had sued to collect a loan for $320,000 on which Henry had defaulted. After Henry was charged with and pleaded guilty to grand theft, the IRS asserted a claim for payment of unpaid taxes exceeding $4,000,000, and the Franchise Tax Board of California sought approximately $1,000,000 in unpaid state taxes.

Hagen interpled the property that Henry transferred to him under the assignment for the benefit of creditors. The United States was joined in the litigation as an additional party in interest.

2. On cross-motions for summary judgment, the district court concluded that the United States' claim for the taxes owed by Henry had priority over petitioners'

unsecured claim in the funds (Pet. App. D4).[1] 31 U.S.C. 3713 provides that "[a] claim of the United States Government shall be paid first" when "a person indebted to the Government is insolvent" and "the debtor without enough property to pay all debts makes a voluntary assignment of property" (31 U.S.C. 3713(a)(1)(A)(i)). The court concluded that the assignment for the benefit of creditors by Henry was an act of insolvency by him and that the tax claim of the United States therefore has priority in the property transferred by Henry on that date under 31 U.S.C. 3713 (Pet. App. A5).

On the date of insolvency, petitioners had only a pre-judgment attachment lien, not a judgment lien or other perfected security interest. The court held that the subsequent perfection of petitioners' lien—by obtaining a judgment and execution levy—did not divest the claim of the United States of the priority it obtained under 31 U.S.C. 3713 on the date the property was transferred by the assignment for the benefit of creditors (Pet. App. A5, A15-A19).

3. The court of appeals affirmed (Pet. App. D1-D10). In *James* v. *United States*, 366 U.S. 213 (1961), this Court held that funds obtained by embezzlement represent taxable income to the embezzler. The court of appeals concluded that the government's claim for the payment of these taxes has priority in the distribution of Henry's assets under 31 U.S.C. 3713(a)(1)(A)(i) because Henry was insolvent at the time he made a voluntary assignment of his property. The court stated that, to de-

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[1] The parties entered into a stipulation of facts for the purpose of determining the priorities of their claims in the interpled funds (Pet. App. A3). Petitioners made no attempt to establish that these funds were in fact their money or could be traced to an account in which their money had been deposited.

feat the priority established for government claims under 31 U.S.C. 3713, the competing lien must be perfected and must have divested the debtor of title to the property *before* the debtor became insolvent and made the voluntary assignment of assets. Because petitioners did not have title to the property, or possession of it, on the relevant date, the court concluded that the federal claim was entitled to priority under 31 U.S.C. 3713 (Pet. App. D5-D9).

4. In an amended opinion (Pet. App. F1-F11), the court of appeals additionally rejected petitioners' claim that the federal priority statute violates the Fifth Amendment to the Constitution. The court noted that the Federal Insolvency Statute is almost as old as the Constitution and "is rooted in the English common law" (Pet. App. F10). The statute "reflects the prerogative of the sovereign to require that debts owed to it be paid before the debts owed to other creditors" (*ibid.*). The court concluded that the statute does not violate due process because, "[a]lthough its application may work hardship on creditors other than the United States, § 3713 is not 'merely arbitrary and capricious'" (Pet. App. F10, quoting *Barclay & Co.* v. *Edwards*, 267 U.S. 442, 450 (1924)). Furthermore, since "the original version of § 3713 was enacted over two hundred years ago, its enactment did not result in a 'taking' of [petitioners'] lien interest" (Pet. App. F10-F11).

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or any other court of appeals. Further review is therefore not warranted.

1. In *James* v. *United States*, 366 U.S. 213 (1961), this Court overruled *Commissioner* v. *Wilcox*, 327 U.S. 404

(1946), and held that embezzled funds represent taxable income to the embezzler in the year of embezzlement. Under 31 U.S.C. 3713, the claim of the United States for the payment of taxes has a first priority when a taxpayer who is "without enough property to pay all debts makes a voluntary assignment of property." 31 U.S.C. 3713(a)(1)(A)(i). See *Bramwell* v. *United States Fidelity & Guaranty Co.*, 269 U.S. 483, 490 (1926).[2]

In this case, the court of appeals correctly held that Henry owed federal income taxes on the funds he embezzled. See *James* v. *United States*, 366 U.S. at 218-220; *Cohen* v. *United States*, 297 F.2d 760, 769 (9th Cir.), cert. denied, 369 U.S. 865 (1962). The court also correctly concluded that Henry was insolvent on November 18, 1986, when he made a voluntary assignment of his property for the benefit of his creditors (Pet. App. D3-D4). Under the plain language of 31 U.S.C. 3713, the claim of the United States is therefore entitled to "be paid first" from the assets transferred by Henry's "voluntary assignment of property" (31 U.S.C. 3713(a)(1)(A)(i)).

Petitioners do not contend that the decision in this case conflicts with the decision of any other court of appeals. To the contrary, other courts have reached the same conclusion in similar factual circumstances. See, *e.g.*, *United States* v. *Gotwals*, 156 F.2d 692, 695 (10th Cir.), cert. denied, 329 U.S. 781 (1946); *Brown* v. *Coleman*, 566 A.2d 1091, 1095-1096 (Md. 1989).

2. Petitioners urge the Court (Pet. 7-12) to modify its decision in *James* v. *United States*, *supra*, in such a manner as to ensure that victims of embezzlement, rather than the United States, will be "paid first" (31 U.S.C. 3713(a)(1)) from the embezzler's assets. Their de-

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[2] This priority provision is expressly inapplicable "to a case under title 11" of the United States Code. 31 U.S.C. 3713(a)(2).

sire to alter the statutory collection scheme that Congress adopted almost 200 years ago should, of course, be directed to the Legislature, not to the courts. Moreover, contrary to petitioners' contention (Pet. 8), the Court was fully aware of the consequences that its decision in *James* would have in the distribution of the embezzler's assets under 31 U.S.C. 3713. The partial dissent of Justice Black in that case noted those specific concerns (366 U.S. at 229):

> All of us know that with the strong lien provisions of the federal income tax law an owner of stolen funds would have a very rocky road to travel before he got back, without paying a good slice to the Federal Government, such funds as an embezzler who had not paid the tax might, perchance, not have dissipated. An illustration of what this could mean to a defrauded employer is shown in this very case by the employer's loss of some $700,000, upon which the Government claims a tax of $559,000.

See also *id.* at 252 (Whittaker, J., concurring in part and dissenting in part). The majority in *James*, however, viewed taxation of illegal gains as essential "to remove the incongruity of having the gains of the honest laborer taxed and the gains of the dishonest immune." *Id.* at 218. See also *id.* at 241 (Harlan, J., concurring in part and dissenting in part).

In short, as the court of appeals correctly concluded, nothing in *James* or in 31 U.S.C. 3713 permits a distinction to be made between the collection of taxes owed from legal or illegal activities. Nor is there any conflict among the courts of appeals on the issue that petitioners request this Court to address.

3. Petitioners further contend (Pet. 12-21) that application of 31 U.S.C. 3713 to the facts of this case violates

the Fifth Amendment to the Constitution. As the court of appeals recognized, however, petitioners held only an unperfected claim against the debtor's estate at the time the federal claim arose (Pet. App. D8-D9). See *United States* v. *Gilbert Associates, Inc.*, 345 U.S. 361, 365-366 (1953); *United States* v. *Waddill, Holland & Flinn, Inc.*, 323 U.S. 353, 355-360 (1945). Application of the federal priority statute to this case does not deprive petitioners of due process of law—every statute regulating the priorities of competing claimants necessarily places some claims ahead of others. As the court of appeals noted, because "taxes are the life-blood of government, and their prompt and certain availability an imperious need" (*Bull* v. *United States*, 295 U.S. 247, 259 (1935)), the priority established by federal law for the collection of taxes is not "merely arbitrary and capricious" (*Barclay & Co.* v. *Edwards*, 267 U.S. 442, 450 (1924)) and does not violate due process (Pet. App. F10).

Moreover, the Federal Insolvency Statute did not effect a "taking" of petitioners' pre-judgment attachment lien interest. This priority statute "is almost as old as the Constitution, and its roots reach back even further into the English common law" (*United States* v. *Moore*, 423 U.S. 77, 80 (1975)). The substantive rights conferred by the statute have remained virtually unchanged since 1797. See, *e.g.*, Act of March 3, 1797, ch. 20, § 5, 1 Stat. 515, as amended by Section 65 of the Act of March 2, 1799, ch. 22, 1 Stat. 676; *United States* v. *Moore*, 423 U.S. at 81. The priority statute advances the public policy of "secur[ing] an adequate revenue to sustain the public burthens and discharge the public debts." *United States* v. *Moore*, 423 U.S. at 81, quoting *United States* v. *State Bank of North Carolina*, 31 U.S. (6 Pet.) 29, 35 (1832). Application of this ancient priority statute to this case does not effect a "taking" of petitioners' lien. Under 31

U.S.C. 3713, the government's lien arose before petitioners perfected their lien by judgment. In view of the fact that the federal statute was enacted in 1797, petitioners obviously cannot claim that their lien was impaired by the subsequent enactment of a statute. See *United States* v. *Security Industrial Bank*, 459 U.S. 70, 78-82 (1982); *Westmoreland* v. *Westmoreland*, 716 F. Supp. 217, 222 (D.S.C. 1988).[3]

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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[3] Petitioners assert that their pre-judgment attachment lien was a property interest within the meaning of the Fifth Amendment. Cf. *Dames & Moore* v. *Regan*, 453 U.S. 654, 689-690 (1981); *Armstrong* v. *United States*, 364 U.S 40, 44-46 (1960). Nevertheless, their lien had not been perfected by judgment and remained contingent at the time of the assignment for the benefit of creditors when the priority of the United States was established under 31 U.S.C. 3713. See *United States* v. *Moore*, 423 U.S. at 85 n.5 (obligations of insolvent debtor are determined "on the facts as they exist at the time of the assignment for the benefit of creditors; subsequent events cannot defeat the obligation").